IN THE COURT OF APPEALS OF TENNESSEE
AT JACKSON
On-Briefs August 8, 2002

RON MCCOLGAN d/b/a BIG SANDY AUTO PARTS v. AUTO-OWNERS INSURANCE COMPANY

A Direct Appeal from the Chancery Court for Benton County
No. 00-168 The Honorable Ron E. Harmon, Chancellor

No. W2002-00114-COA-R3-CV - Filed October 11, 2002

Appellee-insured filed a complaint against appellant-insurance company for breach of contract and bad faith penalties when appellant refused to pay coverage owed under an existing policy for fire damages appellee suffered to his place of business and business personal property. Appellant raised an affirmative defense of arson. Chancery court awarded appellee policy proceeds equal to the coverage limits provided in his policy and a twenty-five percent bad faith penalty pursuant to T.C.A. § 56-7-105. Appellant appeals solely on the issue of the bad faith penalty. We reverse in part, affirm in part and remand.

Tenn. R. App. P. 3; Appeal as of Right; Judgment of the Chancery Court Reversed in Part, Affirmed in Part, and Remanded

W. FRANK CRAWFORD, P.J., W.S., delivered the opinion of the court, in which ALAN E. HIGHERS, J. and DAVID R. FARMER, J., joined.

Dwayne D. Maddox III, Huntingdon, For Appellant, Auto Owners Insurance Company

Terry J. Leonard, Camden, For Appellee, Ron McColgan, d/b/a Big Sandy Auto Parts

OPINION

Appellee Ron McColgan d/b/a Big Sandy Auto Parts ("McColgan")[1] was the owner-operator of Big Sandy Auto Parts, a vehicle parts supply store located in Big Sandy, Tennessee. McColgan also owned a convenience store operated under the name of Buck's Place, located on a lot adjacent

[1] Ron McColgan died on or about May 13, 2002. In an agreed order, Virginia McColgan, the administratrix of Ron McColgan's estate, was substituted as the appellee.

to the auto parts store. After acquiring the auto parts building and existing inventory in 1997,[2] McColgan purchased a fire policy for the parts store from Auto Owners Insurance Company ("Auto Owners"). Pursuant to the terms of the policy, Auto Owners provided replacement cost coverage for the building with limits of $90,000.00 and for business personal property with limits of $30,000.00. Both limits were subject to $500.00 deductibles. The policy also included a $5,000.00 limit for debris removal. The policy term covered the time period from January 10, 2000 through January 10, 2001.

On April 3, 2000, a fire completely destroyed the building that housed McColgan's auto parts business, and the contents and inventory therein. McColgan was in Chattanooga at the time of the fire, working for Orchard Fence Company. He notified the insurance company of the fire, and Auto Owners retained Southern Fire Analysis, Inc. ("SFA") to conduct an investigation of the fire's origin. Jim Jennings ("Jennings"), a certified fire inspector, performed the investigation for SFA. As part of his investigation, Jennings spoke with McColgan, employees of the store, and the local volunteer Fire Chief. After completing his investigation, Jennings concluded that the fire was arson related, pinpointing the direct cause and origin of the fire as arson. According to Jennings' report, the fire originated in the rear corner of the building and was sparked by the intentional use of mineral spirits as an accelerant. McColgan stipulated to the fact that the cause and origin of the fire was arson.

At trial, McColgan testified that he had operated his auto parts business at a loss ever since his purchase in 1997. His testimony revealed that he lost over $22,000.00 on this business in 1998. McColgan further testified that at the time of the fire, he was indebted to various creditors for a total amount exceeding $100,000.00. During the trial, Auto Owners also elicited information from McColgan regarding two prior felony convictions involving drugs and possession of stolen property.

In compliance with the terms of his policy, McColgan filed a claim for the loss of the building and contents. Auto Owners hired Keith Juneau ("Juneau"), an independent claims adjuster with Juneau Property Claims Service, to assess McColgan's claim. In his report, Juneau determined that McColgan's losses exceeded the policy limits. Auto Owners denied the claim.

In a letter dated August 14, 2000, McColgan issued a formal demand for payment of the insurance proceeds. McColgan requested a total reimbursement of $120,000.00, $90,000.00 for losses to his building and $30,000.00 for losses to business personal property. Payment was demanded within 60 days.[3] McColgan further warned that failure to pay the policy proceeds would prompt legal action, in which he would request the court to award damages, prejudgment interest,

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[2] McColgan purchased the building, land, and existing inventory for $55,000.00. Prior to the fire on April 3, 2000, the auto parts building was appraised for tax purposes at $12,800.00. The land upon which the building was located was appraised at $7,300.00. McColgan asserted at trial that these appraisal values were irrelevant for determining the reasonable resale value of the property at the time of loss.

[3] After the formal demand letter of August 14, 2000, McColgan incurred an additional $3,986.00 in expenses for debris removal. He removed the debris at the demand of the city of Big Sandy, Tennessee.

and bad faith penalties pursuant to T.C.A. § 56-7-105. Despite McColgan's request, Auto Owners remained steadfast in its refusal to pay.

On October 20, 2000, McColgan filed suit in chancery court alleging breach of contract. McColgan also sought bad faith penalties under T.C.A. § 56-7-105 for failure of Auto Owners to promptly pay a valid claim. On September 21, 2001, McColgan filed a motion to amend or alter his complaint, praying for the additional recovery of prejudgment interest. The court granted the motion, and a bench trial followed on November 21, 2001.

At the conclusion of the trial, the trial court found that plaintiff had a valid insurance policy with Auto Owners for the coverage heretofore set out, that plaintiff suffered a total loss of the insured property, which is more than the coverage of the policy, and that neither McGolgan, nor any one in his behalf, caused the fire. On December 10, 2001, the court filed a final order stating:

> This cause came on to be heard on this the 21st day of November, 2001, before the Honorable Ron E. Harmon, presiding in the Chancery Court of Benton County, Tennessee, upon the Complaint, Answer, testimony of witnesses and the entire record:
>
> The Court finds that the Plaintiff suffered a fire loss to his building and personal property on April 3, 2000. At the time of the fire, the Plaintiff had a valid insurance policy in effect with the Defendant. The Court further finds that the Plaintiff did not cause the fire nor did he have anyone on his behalf to cause the fire.
>
> IT IS, THEREFORE ORDERED that the Plaintiff is hereby awarded a Judgment against the Defendant, Auto Owners Insurance Company for the loss to his building in the amount of NINETY THOUSAND and 00/100 ($90,000.00) DOLLARS less a five hundred dollar ($500.00) deductible, THIRTY THOUSAND and 00/100 ($30,000.00) DOLLARS less a five hundred dollar ($500.00) deductible for the loss of his contents, THREE THOUSAND NINE HUNDRED EIGHTY SIX and 00/100 ($3,986.00) DOLLARS for the clean up, THIRTEEN THOUSAND FIVE HUNDRED SEVENTY SEVEN and 07/100 ($13,577.07) DOLLARS for prejudgment interest from October 14, 2000 through November 21, 2001 which is calculated for 403 days at a rate of $33.69 per day and TWENTY NINE THOUSAND SEVEN HUNDRED FIFTY DOLLARS ($29,750.00) DOLLARS for bad faith penalties which is 25% of the total judgment regarding Plaintiff's building and contents.
>
> IT IS FURTHER ORDERED that the said attorney for Plaintiff recover his discretionary costs from the Defendant in the

> amount of $147.20 and that same be assessed as court costs and more specifically Defendant is ordered to pay to Terry J. Leonard reimbursement for the following: Doris Harris, Court Reporter (deposition of parties) in the amount of $147.20.
>
> WHEREFORE, IT IS ORDERED that the Plaintiff is hereby awarded a Judgment against the Defendant, Auto Owners Insurance Company for the total amount of ONE HUNDRED SIXTY SIX THOUSAND THREE HUNDRED THIRTEEN and 07/100 ($166,313.07) DOLLARS, plus discretionary cost in the amount of ONE HUNDRED FORTY SEVEN and 20/100 ($147.20) DOLLARS, plus additional prejudgment interest at a rate of $33.69 per day from November 22, 2001 through the entry of this Order.
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> IT IS FURTHER ORDERED that the Defendant pay the costs of the cause for which let execution issue if necessary.

Auto Owners has appealed and presents the sole issue for review, as stated in its brief: "Did the trial court err in allowing statutory bad faith penalties under Tennessee Code Annotated § 56-7-105 based upon the proof offered by the plaintiff?"

Since the case was tried by the court sitting without a jury, we review the case de novo upon the record with a presumption of correctness of the findings of fact by the trial court. Unless the evidence preponderates against the findings, we must affirm, absent error of law. T.R.A.P. 13(d).

Section 56-7-105(a) (2000) of the Tennessee Code Annotated provides:

> The insurance companies of this state, and foreign insurance companies and other persons or corporations doing an insurance or fidelity bonding business in this state, in all cases when a loss occurs and they refuse to pay the loss within sixty (60) days after a demand has been made by the holder of the policy or fidelity bond on which the loss occurred, shall be liable to pay the holder of the policy or fidelity bond, in addition to the loss and interest thereon, a sum not exceeding twenty-five percent (25%) on the liability for the loss; provided, that it is made to appear to the court or jury trying the case that the refusal to pay the loss was not in good faith, and that such failure to pay inflicted additional expense, loss, or injury including attorney fees upon the holder of the policy or fidelity bond; and provided further, that such additional liability, within the limit prescribed, shall, in the discretion of the court or jury trying the case, be measured by the additional expense, loss, and injury including attorney fees thus entailed.

This statute is penal in nature, and therefore must be strictly construed. ***Minton v. Tennessee Farmers Mut. Ins. Co.***, 832 S.W.2d 35, 38 (Tenn. Ct. App. 1992).

To recover bad faith penalties under T.C.A.§ 56-7-105, the claimant must prove the following:

> (1) the policy of insurance must, by its terms, have become due and payable, (2) a formal demand for payment must have been made, (3) the insured must have waited 60 days after making demand before filing suit (unless there was a refusal to pay prior to the expiration of the 60 days), and (4) the refusal to pay must not have been in good faith.

Minton, 832 S.W.2d at 38 (citing ***Palmer v. Nationwide Mutual Fire Ins. Co.***, 723 S.W.2d 124, 126 (Tenn. Ct. App. 1986)).

The burden of proving that an insurance company acted in bad faith in refusing to pay a claim lies with the insured. ***See Nelms v. Tennessee Farmers Mut. Ins. Co.***, 613 S.W.2d 481, 484 (Tenn. Ct. App. 1978) (citing ***Life & Casualty Ins. Co. v. Robertson***, 6 Tenn. App. 43 (1927); ***Pittman v. Missouri State Life Ins. Co.***, 12 Tenn. App. 228 (1930)). The issue of bad faith is a fact determination. ***See Mason v. Tennessee Farmers Mut. Ins. Co.***, 640 SW.2d 561, 567 (Tenn. Ct. App. 1982).

In finding Auto Owners liable under its policy, the chancellor concluded that the loss was caused by a fire "of unknown origin" and that McColgan was not responsible in any manner for causing the fire. The Chancellor noted that McColgan fully cooperated with the investigation conducted by Auto Owners, adequately complied with the claim notification terms of the policy, and made a valid and timely formal demand for payment. The chancellor's award of bad faith penalties was based on his finding that Auto Owners was not justified in withholding payment on McColgan's claim, as there was no proof tying him to the fire loss or the cause of the fire. Auto Owners put on no proof at the trial, and there simply is no proof in the record justifying Auto Owners denial of McColgan's claim. The evidence does not preponderate against the findings of the chancellor.

The parties do not dispute the factual conclusions in Jennings' report to SFA that the fire was caused by arson. Instead, the underlying dispute in this case is whether McColgan presented sufficient evidence to prove that Auto Owners acted in bad faith in denying his claim. Auto Owners argues that a bad penalty under T.C.A. § 56-7-105 should not be given against an insurance company absent a finding of "moral turpitude." It contends that its denial of McColgan's claim was not motivated by moral turpitude. Rather, Auto Owners argues that it was justified in denying the claim for the following reasons. First, the fire was intentionally set using mineral spirits as an accelerant. Second, McColgan was a convicted felon with a total indebtedness exceeding $100,000.00. Third, McColgan's business operated at a loss for four straight years. Yet, under the terms of his policy, McColgan could finally realize a profit on the business, as he stood to recover losses in excess of his

initial investment. Auto Owners asserts that, considered together, all of these factors suggest a motive for arson and, at the very least, constitute a good faith basis for denial of McColgan's claim.

Despite the "suspicious" nature of the circumstantial evidence proffered by Auto Owners, we find that McColgan has presented sufficient evidence to support a finding of bad faith. Although the evidence noted above lends credence to an arson motive, under the circumstances, the failure of the Auto Owners to pay was not in good faith. McColgan produced evidence that he complied fully with the policy requirements for notification of claims and demand of payment, that the policy was valid, and that the policy covered the type of loss suffered. Additionally, he offered a verifiable explanation for his whereabouts on the morning of the fire and the days leading up to the loss. Most importantly, we find that the McColgan has sufficiently proven a lack of good faith by demonstrating that the record contains no evidence connecting him to the fire or its cause. As a result, Auto Owners was not justified in withholding payment on McColgan's claim. Auto Owners' refusal to honor the policy terms without any justification constituted bad faith.

McColgan satisfied the recovery requirements of § 56-7-105 by introducing evidence that he suffered a loss to his building and business personal property which was protected under a valid fire insurance policy providing coverage. McColgan filed his suit against Auto Owners on October 20, 2000, more than 60 days after his formal demand for payment of August 14, 2000. Additionally, McColgan testified that he incurred additional expense in the form of attorney fees as a result of Auto Owners' refusal to honor the policy. However, we have searched the record for any proof of the amount of such fees but cannot find such proof. The bad faith penalty statute allows for recovery of an amount ***up to*** twenty-five percent of the amount of loss and is "measured by the additional expense, loss, or injury inflicted upon the defendant by reason of the suit." T.C.A. § 56-7-105 (2000). This so-called penalty is not simply a punitive award but allows for the recovery of the additional damages caused by a breach of the insurance policy. ***See Rice v. Van Wagoner Cos.***, 738 F.Supp. 252 (M.D. Tenn. 1990). In considering an award of the "bad faith" penalty, this Court, in ***Ray v. Shelter Ins. Co.***, No. 01A01-9208-CV-00324, 1993 WL 15151, at *2 (Tenn. Ct. App. Jan. 27, 1993), said:

> This is a penal statute, and must be strictly construed. ***St. Paul fire & Marine Ins. Co. v. Kirkpatrick***, 129 Tenn. 55, 164 S.W. 1186 (1913). However, Section 56-7-105 does not require an automatic twenty-five percent penalty upon a finding that the insurance company's failure to pay was in bad faith merely because it is a penal statute. There must be a showing that the "failure to pay inflicted additional expense, loss, or injury upon the holder of the policy or fidelity bond." The burden is upon the plaintiff to show such additional expense, loss, or injury.

Under the circumstances, and in considering the entire record, we find that this a proper case to invoke the provision of T.C.A. § 27-3-128 (2000), which provides:

> **27-3-128. Remand for correction of record.** The court shall also, in all cases, where, in its opinion, complete justice cannot be had by reason of some defect in the record, want of proper parties, or oversight without culpable negligence, remand the cause to the court below for further proceedings, with proper directions to effectuate the objects of the order, and upon such terms as may be deemed right.

Accordingly, the judgment of the trial court awarding plaintiff-appellee $29,750.00 as bad faith penalty is reversed, and the judgment in all other respects is affirmed. The case is remanded to the trial court for further proceedings to determine the amount of the bad faith penalty consistent with this Opinion. Costs of the appeal are assessed one-half against the plaintiff-appellee, Ron McColgan, d/b/a Big Sandy Auto Parts, and one-half against the defendant-appellant, Auto Owners Insurance Company, and its surety.

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W. FRANK CRAWFORD, PRESIDING JUDGE, W.S.